CORRECTED DIRECT TESTIMONY

OF

SHEENA KIGHT

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

ILLINOIS CONSOLIDATED TELEPHONE COMPANY

DOCKET NO. 02-0124

MARCH 12, 2002

Q. Please state your name and business address.

A. My name is Sheena Kight. My business address is 527 East Capitol Avenue, Springfield, Illinois 62701.

Q. By whom are you employed and in what capacity?

A. I am employed by the Illinois Commerce Commission ("Commission") as a Financial Analyst in the Finance Department of the Financial Analysis Division.

Q. Please describe your qualifications and background.

A. In May of 1998, I received a Bachelor of Business degree in Finance and Marketing from Western Illinois University in Macomb, Illinois. I earned a Master of Business Administration degree, with a concentration in Finance, also at Western Illinois University in May 2001. I have been employed by the Commission in my present position since January of 2001.

Q. Please state the purpose of your testimony in this proceeding.

A. The purpose of my testimony is to present my evaluation of Illinois Consolidated Telephone Company's ("ICTC") proposed reorganization pursuant to Section 7-204(b)(4) of the Illinois Public Utilities Act, 220 ILCS 5/1-101 *et seq.* ("Act"). ICTC, a subsidiary of McLeodUSA Incorporated, filed an application for approval of the Reorganization Plan filed in McLeodUSA Incorporated's Chapter 11 proceeding. My evaluation focuses on the financial implications of the proposed reorganization on ICTC's ability to access the capital markets on reasonable terms.

Q. Why is it necessary to evaluate the financial implications of the proposed reorganization?

A. In order to approve a proposed reorganization, Section 7-204(b)(4) of the Act requires the Commission to find that "the proposed reorganization will not significantly impair the utility's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure."

Q. Please summarize your findings.

A. In my opinion, the proposed reorganization, subject to the commitments proposed in Exhibit 3.01 to this testimony, meets the requirements of Section 7-204(b)(4) of the Act.

Q. Please describe the corporate relationship between ICTC and McLeodUSA Incorporated.

A. ICTC is a wholly owned subsidiary of McLeodUSA Community Telephone, Inc. McLeodUSA Community Telephone, Inc. is a wholly owned subsidiary of McLeodUSA Holdings, Inc., which is a wholly owned subsidiary of McLeodUSA Incorporated. ICTC will remain a wholly owned subsidiary of McLeodUSA Incorporated upon completion of the proposed reorganization. However, McLeodUSA Incorporated's common equity ownership interest will change. After the reorganization, Forstmann Little will have a controlling interest in 58% of McLeodUSA Incorporated's outstanding common stock.[1]

Q. How does ICTC raise capital?

A. McLeodUSA Incorporated and ICTC are responsible for raising debt or equity capital on behalf of ICTC.[2] ICTC has been able to satisfy all capital needs through cash generated from its operations. If ICTC were to require additional debt capital from external sources it would issue long-term debt directly.[3] McLeodUSA Incorporated would be responsible for raising the equity capital if ICTC were to require it.

Q. What is your assessment of ICTC's financial condition?

A. On a standalone basis, ICTC's financial condition is very strong.

Q. How did you reach that conclusion?

A. For the 1999-2001 period, I computed four measures of ICTC's financial strength: pre-tax interest coverage, funds from operations interest coverage, total debt to total capital, and net cash flow to total debt ratios and compared the results to financial medians Standard & Poor's (S&P) publishes for telecommunications companies by credit rating. As the table below shows,

[1] McLeodUSA Ex. 2.0 (Ceryanec Direct), p 4.
[2] McLeodUSA Ex. 2.0 (Ceryanec Direct), p. 2.
[3] ICTC's response to Staff data requests SK-4.4 – SK-4.5. (Attached hereto as Exhibit 3.02).

ICTC's ratios are consistent with an S&P rating of at least AA.[4, 5]. An obligor rated AA has a very strong capacity to meet its financial commitments.[6]

Ratio	1999	2000	2001	S&P "AA" Financial Medians [7]
Pre-tax Interest Coverage	10.94x	10.23x	12.68x	Over 4.5x
FFO Interest Coverage	18.8x	15.3x	13.9x	Over 6.5x
Total Debt to Total Capital	28.7%	28.7%	26.1%	Under 42%
Net cash flow to Total Debt	226%	168%	72.6%	Over 32%

Q. Please describe McLeodUSA Incorporated's financial condition.

A. McLeodUSA Incorporated has an S&P credit rating of D.[8] An obligor rated D is in payment default or has filed a bankruptcy petition.[9] McLeodUSA Incorporated filed Chapter 11 bankruptcy on January 31, 2002.[10]

Q. Please describe how McLeodUSA Incorporated's financial condition could impact ICTC's ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure.

[4] ICTC's response to Staff data requests SK 1.01-SK 1.09. (Attached hereto as Exhibit 3.03)
[5] Standard & Poor's, *Financial Medians: Telecommunications Companies,* June 16, 1999, p. 1.
[6] Standard & Poor's, Global Utilities Rating Service Ratings, User Guide, p.4.
[7] Standard & Poor's, *Financial Medians: Telecommunications Companies*, June 16, 1999, p. 1.
[8] Standard & Poor's, Ratings Direct, McLeodUSA Inc., January 31, 2002.
[9] Standard & Poor's, Global Utilities Rating Service Ratings, User Guide, p.4.
[10] McLeodUSA Ex. 2.0 (Ceryanec Direct), p.5

A. Given its default on its debt obligations, McLeodUSA Incorporated should have great difficulty accessing the capital markets on reasonable terms. Since equity investors have only a residual claim to the assets of a company, they would be reluctant to take an ownership stake in a firm which is currently in default on its debt obligations. Furthermore, McLeodUSA Incorporated states that it expects to generate negative cash from operations until fiscal 2005 and acknowledges that "access to the amounts that remain available to borrow under the Credit Agreement are critical in funding McLeodUSA's operations."[11] That is, McLeodUSA will be a net user of cash for the foreseeable future. Consequently, should ICTC need external equity capital, McLeodUSA is unlikely to be in a position to raise it.

Although ICTC may generate sufficient funds to support its operations, the proposed reorganization offers no guarantee that McLeodUSA Incorporated would not draw upon those funds to support its operations to the detriment of ICTC. In fact, McLeodUSA Incorporated's credit agreement appears to forbid McLeodUSA Incorporated from agreeing to restrict dividend payments from certain subsidiaries including ICTC.[12] Given ICTC's reliance on internally generated cash flows to meet its capital requirements and McLeodUSA Incorporated's poor financial condition and its projected losses in the near term, excessive remittance of dividends by ICTC is not an implausible scenario. If ICTC were to remit dividends in excess of its "free cash flow,"

[11] ICTC Application, Docket No. 02-0124, Exhibit C, p.62
[12] McLeodUSA Incorporated Credit Agreement, Section 6.11, May 31, 2000, p. 86

ICTC's capital structure would weaken and could significantly impair ICTC's ability to raise replacement capital.[13]

Q. Has the Commission confronted this situation in other reorganizations?

A. Yes. In Docket 99-0237, a company with a very weak financial condition, Global Crossing, proposed to acquire Frontier Communications of Illinois, Inc., Frontier Communications of Lakeside, Inc., Frontier Communications of Mt. Pulaski, Inc., Frontier Communications of DePue, Inc., Frontier Communications of Orion, Inc., Frontier Communications-Midland, Inc., Frontier Communications-Prairie, Inc., Frontier Communications-Schuyler, Inc., (collectively "Frontier Companies"). To ensure that the proposed reorganization did not significantly impair the ability of the Frontier Companies to raise capital on reasonable terms and to maintain a reasonable capital structure, the Commission imposed three conditions on the reorganization.[14] The first condition addressed the terms for capital. It assured that in the event of a rate case the utility's cost of capital will be set commensurate to the risk of that utility exclusive of the effects of the proposed reorganization. The second condition insulated the utility and its assets from the debts and obligations of its affiliates and further assured that the poor financial condition of the utility's ultimate parent company rates did not increase the cost of the utility's debt. The third condition ensured that the utility retained sufficient funds to maintain

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[13] "Free cash flow" is the Company's net cash from operations, including changes in working capital, less construction expenditures, less maturing debt, less mandatory redemptions of debt and preferred stock, plus capitalized interest (AFUDC), plus any undistributed free cash flow.

[14] Order, Docket 99-0237, September 28, 1999, pp. 7-9

service quality at a reasonable level since only utility cash flows in excess of utility requirements could be transferred to affiliated companies.

Q. Do you recommend that the Commission impose the same three conditions on this proposed reorganization?

A. No. I recommend that the Commission impose the first two conditions; however, I recommend replacing the free cash flow test with a dividend-reporting requirement. The three conditions I propose, including the dividend-reporting requirement, are presented in Exhibit 3.01.

Q. Please explain why you are recommending replacing the free cash flow test with a dividend-reporting requirement.

A. First, McLeodUSA is committed to selling ICTC within 14 months of the consummation of the reorganization plan.[15] Second, Staff recognizes that the free cash flow test may conflict with an existing credit agreement that appears to restrict McLeodUSA Incorporated and its subsidiaries from entering into any agreement that would prohibit, restrict, or impose any condition upon the remittance of dividends.[16] Although this in itself would not preclude the Commission from restricting dividends to protect the financial condition of a regulated utility, in an effort to resolve issues in this proceeding, I recommend replacing the free cash flow test with a dividend-reporting requirement. A

[15] ICTC Application, Docket No. 02-0124, Exhibit C, p.33

[16] *McLeodUSA Incorporated Credit Agreement, Section 6.11, May 31, 2000, p. 86*

dividend-reporting requirement would facilitate monitoring of ICTC's cash dividend payments to ensure that such payments do not impair ICTC's capital.

Q. Please describe the commitments that would place the proposed reorganization in compliance with the requirements of Section 7-204(b)(4) of the Act.

A. Exhibit 3.01 to this testimony provides the commitments that ICTC must agree to in order to be in compliance with the requirements of Section 7-204(b)(4) of the Act. Commitment 1 addresses the terms for capital. It assures that in the event of a rate case ICTC's cost of capital will be set commensurate to the risk of ICTC exclusive of the effects of the proposed reorganization. Commitment 2 insulates ICTC and its assets from the debts and obligations of their affiliates and further assures that rates will not reflect an increased cost of debt caused by the poor financial condition of its ultimate parent company. Commitment 3 would ensure that ICTC's capital is not significantly impaired, by requiring ICTC to report the declaration of dividends.

Q. Does this conclude your direct testimony?

A. Yes, it does.

Exhibit 3.01

Commitments

1. Applicant agrees and commits that the cost of capital, as reflected in ICTC's rates, shall not be adversely affected by the reorganization of McLeodUSA Incorporated. Applicant also agrees and commits that, subsequent to the completion of the reorganization, the cost of capital for ICTC in any future earnings analysis or rate base/rate of return case shall be set commensurate with the risk of ICTC exclusive of any reorganization effects. Applicant agrees and commits that it will not oppose, in either a regulatory proceeding or an appeal of a decision by the Commission, the application of the principle that the determination of the cost of capital shall be based solely on the risk attendant to the regulated operations of ICTC. Any declines in ICTC's financial condition caused by the reorganization or its announcement shall be quantified by the Applicant in any future earnings analysis, or rate base/rate of return case and adjusted as if such declines did not occur. Applicant agrees and commits to the use of any imputed or hypothetical capital structure in any future earnings analysis, or rate base/rate of return rate case, if necessary to reflect the cost of capital for ICTC without the effects of the reorganization.

2. Applicant shall not allow any affiliate of ICTC, including McLeodUSA Incorporated, to obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to ICTC's assets. The financial arrangements of all affiliates of ICTC, including McLeodUSA Incorporated, are subject to the following restrictions:

   a. Any indebtedness incurred by an affiliate, including McLeodUSA

Incorporated, will be without recourse to ICTC.

b. ICTC shall not enter into any agreements under terms whereby ICTC is obligated to commit funds in order to maintain the financial viability of an affiliate, including McLeodUSA Incorporated.

c. ICTC shall not make any investment in an affiliate, including McLeodUSA Incorporated, under circumstances in which ICTC would be liable for the debts and/or liabilities of an affiliate incurred as a result of acts or omissions of an affiliate, including McLeodUSA Incorporated.

d. ICTC shall not issue any security for the purpose of financing the acquisition, ownership, or operation of an affiliate, including McLeodUSA Incorporated.

e. ICTC shall not assume any obligation or liability as guarantor, endorser, surety or otherwise with respect to any security of an affiliate, including McLeodUSA Incorporated.

f. ICTC shall not pledge, mortgage or otherwise use as collateral any assets of any of ICTC for the benefit of an affiliate, including McLeodUSA Incorporated.

g. Applicant shall assure that rates to the regulated service customers of ICTC are not increased by reason of the effects of credit rating declines or other adverse consequences caused directly by the reorganization.

h. An affiliate, including McLeodUSA Incorporated, shall not incur debt or pledge the stock of ICTC, or any of them, in any manner that on the affiliate's default would permit a creditor to have recourse against the regulated assets of ICTC.

3. Dividend transfers from ICTC to affiliated companies during any calendar year shall be reported to the Illinois Commerce Commission ("Commission") within one week of the declaration of dividends.

"Dividend transfers" shall be defined as the amount of common dividends directly or indirectly remitted to affiliated companies.

Within 1 week following the declaration of dividends by ICTC as specified above, the Company shall submit a report of the declaration of dividends to the Manager of the Finance Department and the Office of the Chief Clerk. ICTC shall also submit financial statements for the last 12-month period available at the time of the dividend declaration report to the Commission's Manager of the Finance Department

If McLeodUSA Incorporated's senior debt is rated at least Baa2 by Moody's or its successors or BBB by Standard & Poor's or its successors, or if ICTC is no longer owned or controlled by McLeodUSA Incorporated, upon notification to the Office of the Chief Clerk and the Manager of the Finance Department, compliance with the dividend reporting requirement will not be necessary and the submission of financial statements may be suspended.

Exhibit 3.02

The Company's response to Staff data request SK-4.4 - SK-4.5.

SK-4.4) Please describe how ICTC has raised debt capital in the past.

Response: ICTC has issued first mortgage bonds through private placement firms. ICTC's current debt ($20M total) was secured in the early 1990's. Half of that amount was originated on 9/1/1992 and the other half on 10/1/1993.

Response prepared by Gary Patrem, Controller for ICTC

SK-4.5) Please describe how ICTC will raise debt capital after the proposed reorganization.

Response: Present projections will not require ICTC to acquire additional debt capital, as cash from operations is sufficient to fund its projected plant additions. ICTC has no current plans to raise additional debt capital. If a decision was made to accelerate plant additions from the current planned deployment schedule, additional capital might be needed. If that were the case, ICTC expects that it would raise the debt capital in a manner similar to that described in the response to SK-4.4.

Response Prepared by Gary Patrem, Controller for ICTC

Exhibit 3.03

The Company's response to Staff data request SK-1.01 - SK-1.09.

Item SK-1.1

SK-1.1) Please indicate which entity is currently responsible for raising debt capital on behalf of Illinois Consolidated Telephone Company (ICTC). In addition, please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for that entity for the last three fiscal or calendar years.

Response: See Prepared Direct Testimony of Joseph H. Ceryanec, lines 48- 66. The ICTC balance sheet, income statement and cash flow are set forth in ICTC Ex. 2.1. The audited financial statements of McLeodUSA Incorporated for the last three years are being sent under separate cover for delivery to Staff on March 5, 2002.

Item SK-1.2

SK-1.2) Please indicate which entity will be responsible for raising debt capital on behalf of ICTC upon completion of the reorganization proposed in this Docket. In addition, please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for that entity for the last three fiscal or calendar years.

Response: See Response to SK-1.1

Item SK-1.3

SK-1.3) Please indicate which entity will be responsible for raising equity capital on behalf of ICTC upon completion of the reorganization proposed in this Docket. *In addition, please provide the audited financial* statements (balance sheet, income statement, and cash flow statement) for that entity for the last three fiscal or calendar years.

Response: See Response to SK-1.1.

Item SK-1.4

SK-1.4) Please provide the audited financial statements (balance sheet, income statement, cash flow statement, and statement of retained earnings) for ICTC for the last three fiscal or calendar years.

Response: See ICTC Exhibit 2.1

Item SK-1.5

SK-1.5) Please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for McLeodUSA Inc. for the last three fiscal or calendar years.

Response: See Response to SK-1.1

Item SK-1.6

SK-1.6) Please provide pro forma financial statements (balance sheet, income statement, and cash flow statement) for McLeodUSA Community Telephone Inc. (McLeodUSA CTI) upon completion of the reorganization proposed in this Docket for the period provided in Exhibit D to the Company's Application. Provide a list of all major forecasting assumptions used to derive the pro forma data.

Response: McLeodUSA does not maintain separate financial statements from McLeodUSA Community Telephone Company. The pro forma financial statements for McLeodUSA Incorporated for the years 2002 through 2005 are set forth in the Appendix C to ICTC Exhibit 2.2. Projected financial statements have not been prepared for 2006.

Item SK-1.7

SK-1.7) Exhibit D of the Petition in Docket 02-0124 presents the debt to equity ratio before the reorganization, please provide a forecast of debt to equity ratios after the proposed reorganization for 2002-2006.

Response: Attachment D to the Petition is not valid. ICTC Exhibit 2.1, Schedule A, which replaces Exhibit D, shows that ICTC's projected debt to total permanent capital ratio is remaining relatively consistent over the next five years, 25% in 2002 going to 21% by 2006.

Item SK-1.8

SK-1.8) Please explain why the Retained Earnings of ICTC shown on Exhibit D to the Company's Petition are forecasted to decline every year.

Response: ICTC Exhibit 2.1, Schedule A, which replaces Exhibit D, shows that *retained earnings will be increasing between 2002-2006.*

Item SK-1.9

SK-1.9) Please describe any measures enacted to protect ICTC from its parent companies' creditors.

Response: See Prepared Direct Testimony of Joseph H. Ceryanec, lines 68-72.